Date: June 10, 2002

To: Councilmember Jim Compton, Chair, Police, Fire, Courts and Technology Committee

Via: Regina LaBelle, Counsel to Mayor Greg Nickels

From: Tony Perez, Director, Seattle Office of Cable Communications

Re: Report on AT&T Comcast Request for Consent to Application for Transfer of Control

Introduction

On March 4, 2002 AT&T Broadband (AT&T), the City's predominant cable operator and parent company of TCI Cablevision of Washington and United Community Antenna Systems , its subsidiaries and holders of the franchise in the City of Seattle (Franchisees) , filed with the City a Federal Communications Commission (FCC) Form 394.This is a formal request for the City's consent to AT&T's merger with Philadelphia-based Comcast Corporation and the transfer of their combined assets and liabilities to a new corporate entity, AT&T Comcast.

Federal law requires that the City act on this transfer request within 120 days from receipt of a complete form 394; if no action is taken within 120 days, consent is assumed by operation of law. SMC 21.60 and AT&T's franchise agreement require AT&T to obtain the City's approval prior to the transfer, or the exisitng franchise could become subject to revocation. The City may not unreasonably withhold its consent and Council's determination must be rendered by ordinance. The Municipal Code also requires a public hearing to give citizens an opportunity to express their views orally or in writing regarding the transfer. A public hearing regarding this proposed transfer has been scheduled for June 11, 2002 at 4:00 p.m. in Council Chambers, before the Public Safety, Police, Fire, Courts and Technology Committee. The Committee will also deliberate on the transfer issue in its meeting of June 19, 2002.

To assist the Council during this process and pursuant to SMC 21.60 the Office of Cable Communications (OCC) provides this analysis of the proposed transfer. This report uses information from the submitted FCC form 394, responses from AT&T Comcast to questions submitted by the City, press releases, our consultant's financial analysis, other reports, and publicly available information. In our analysis, and after lengthy review, the OCC recommends approval of the proposed transfer, subject to certain conditions and commitments to protect the City's interests.

Scope of Review:

The Office of Cable Communications report is based primarily on the guidelines provided in the Seattle Municipal Code 21.60. SMC 21.60.260 requires that the Council approve or deny the request for transfer based upon the following criteria: AT&T Comcast's ability to show financial responsibility (as determined by the Council) and to demonstrate to the Council's satisfaction the company's ability to comply with the provisions of the franchise and Seattle Municipal Code 21.60 and all other applicable laws. In addition other factors the Council shall consider are: the quality of the proposed service; the experience, character, background and financial responsibility of the applicant and its management and owners; the technical and performance quality of the equipment, including the technical ability to satisfy obligations under the franchise agreement; the program proposed for construction: and the applicant's ability to meet construction and physical requirements. Since AT&T cable system in Seattle is fully built out this Office does not believe it necessary to evaluate the proposed construction program, nor the applicant's ability to meet construction and physical requirements. We would be happy to provide Council with this information if desired.

I. Background

Descriptions of AT&T Broadband and Comcast

On February 16, 1999 the Council adopted Ordinance Number 119381 approving the transfer of control of TCI and United Community Antenna (holders of the Seattle franchises) whose current franchise expires on January 20, 2006, to AT&T Broadband and its corporate parent AT&T Corp.. AT&T Broadband provides cable television, Internet and telephony services to approximately 150,000 subscribers in Seattle, including 42,000 cable modem customers. AT&T's local service area includes all of Seattle with the exception of the Central District Franchise Area and the Central Business Franchise District where AT&T and Millennium Digital Media each currently provides service under permit authority. AT&T Broadband is the largest cable operator in the country. Nationally the company serves approximately 13.6 million subscribers. It also owns interests in other cable systems most notably a 25.5 % interest in Time Warner Entertainment.

Comcast Corporation is the third largest cable operator in the country with approximately 8.5 million cable subscribers. Comcast also owns the QVC home shopping network as well as interests in a number of programming providers such as the Golf Channel and professional sport operations. Comcast has an industry reputation of being a well run cable operator.

Description of the Merger

AT&T Corp., the parent company of AT&T Broadband, will spin off AT&T Broadband (its cable television and related broadband operations, assets, and liabilities) and AT&T Broadband will simultaneously merge with Comcast Corporation, creating a new corporate entity, AT&T Comcast Corporation. AT&T Chairman, C. Michael Armstrong, will be chairman of AT&T Comcast, and Comcast president Brian Roberts will be President and CEO. Mr. Roberts will also own or control about 33% of the voting control of AT&T Comcast once the merger closes. No other shareholder will own more than 5%.

The combined entity will pass about 38 million homes and have about 22 million customers in 41 states, including a presence in 17 of the 20 largest metropolitan areas in the US. AT&T Comcast would be the largest cable company in the world with annual projected revenue of $19 billion. After the transaction is completed the Franchisees will remain intact and be subsidiaries of AT&T Comcast as will Comcast and AT&T Broadband LLC. (Please see Attachment A for an organizational chart illustrating all AT&T Comcast legal entities in the corporate chain between AT&T Comcast and the Franchisees.) AT&T Corp will retain its telecom assets such as long distance and wireless. The merger documents indicate that there will be some contractual agreements between AT&T Comcast and AT&T Corp., including the provisioning by AT&T Corp. of services used in the delivery of AT&T Comcast Internet service and AT&T Comcast will also construct and lease to AT&T Corp. fiber facilities in some areas served by AT&T Broadband. As part of the proposed deal, Microsoft Corporation has agreed to convert $5 billion in preferred stock it owns in AT&T into 115 million shares of AT&T Comcast stock

II. Legal Qualifications, Character, Experience, and Background of the Applicant and its Management and Owners

AT&T Comcast has been established and duly incorporated in Pennsylvania. The Franchisees are Washington corporations authorized to do business in the state of Washington. As discussed above the Franchisees will not change as a result of the transaction. The OCC is satisfied that there are no legal issues. This Office has also determined that there are no indications that would call into question the character of any current officers or directors of AT&T Comcast. We do not know if AT&T Comcast plans to change management personnel but the franchise requires the Franchisees "to maintain a local management presence within King County by maintaining management level positions in network administration, customer service and support, construction engineering, and high speed data services, and support staff sufficient to fulfill all franchise responsibilities." AT&T Comcast asserts that the transfer of control will not have any effect on the binding nature of the franchise agreements.

III. Analysis of Financial Qualifications

The Office of Cable Communications was assisted in our financial review of the merger by KFA Services, which has extensive experience in the financial workings of cable operators. (The KFA report is attached as Exhibit B) KFA states that from a financial perspective there are some benefits to the City. In its report KFA points out that the new entity will be in stronger financial position than AT&T Broadband alone. Other findings from KFA:

- There will be no new net borrowings required or reductions in cash reserves;
- The conversion of about $5 billion in preferred stock of AT&T Broadband owned by Microsoft into common stock will relieve AT&T Comcast of possible future cash dividend obligations;

- Comcast is relatively strong financially and the combined AT&T Comcast should be stronger than AT&T Broadband alone which has a very high debt to cash flow ratio of 11:1.

According to the KFA report there are some negatives to the proposed merger:

- AT&T Comcast will not initially be as strong as the current parent of AT&T Broadband, AT&T Corp. AT&T Corp. had revenues of $52.6 billion in 2001, and currently enjoys a higher bond rating than AT&T Broadband or Comcast. AT&T Corp. has previously subsidized AT&T Broadband's operations but will no longer be able to after the merger. KFA does point out that because of declining revenues from its long distance telephone business, the loss of AT&T Corp. support may be ultimately less important than in the past.

- AT&T Comcast will be highly leveraged. As part of the deal, AT&T Comcast assumes from AT&T Corp. $19.3 billion of AT&T Broadband debt and $12.2 billion of Comcast debt. KFA points out that ATT Comcast's pro forma debt-to-cash ration of 7.5 is at the high end of industry norms. KFA believes that this situation may improve as each company tries to reduce debt before the merger is concluded. AT&T Broadband has indicated that it may try to sell its 25.5% stake in Time Warner, to reduce its debt burden. AT&T Comcast has also indicated that it intends to improve operating margins and reduce debt in the next few years. The report expressed concern that servicing the debt load and achieving operating efficiencies may cause AT&T Comcast to increase revenues by raising prices or reducing expenses and possibly cutting back on customer service levels or on investments necessary to roll out advanced broadband services.

The City is preempted by federal law from regulating almost all rates cable rates. Although we can hope that market forces will keep rates from rising much higher. Due to concerns about cutbacks to customer service, the Office of Cable Communications will recommend that the transfer ordinance require AT&T Comcast to agree that it will take no action that will impair the Franchisees' ability to abide by the franchise and the Cable Customer Bill of Rights.

The assumed debt load, while very significant, would be a more crucial concern to the City if AT&T Comcast were inheriting an antiquated local cable system with obligations to invest sizable capital outlays in order to upgrade or rebuild. In Seattle, because of our work with AT&T Broadband at the time of the TCI transfer, the AT&T Broadband cable system is fully built-out as a two-way, 750 megahertz system capable of providing digital cable television, Internet and telephony service.

There has been concern expressed that AT&T Comcast's financial and management structure would allow it to operate in manner that lacks financial transparency and thus obscure the flow of revenue diverted from the local franchisees to the parent company. If this out-migration is too great it may jeopardize the ability of the Franchisees to abide by its commitments. While acknowledging the validity of this concern this Office notes that

ATT Comcast will provide 10k reports to the Securities and Exchange Commission and such reports will be available for public review. In addition the current franchise agreement provides the City with authority to require AT&T Comcast and its local affiliates to provide the following financial information: “A list of all petitions, applications, communications, and reports having a direct and material effect on the Cable System, submitted by the Grantee and its Parent Corporations to the FCC, the Securities and Exchange Commission or any other federal or state regulatory agency. Grantee shall make copies of any such Documents and any related communications with the respective agencies available to the City upon request." The current franchise states further that the City may require the following financial information:

- Financial statements for Grantee's Seattle Area Cable System and, separately, for its Cable System within the City, prepared in accordance with generally accepted accounting principles.

- Franchisees’ (or ultimate parent company) … annual corporate reports, including their audited financial statements;

- Statement describing joint ventures or partnerships in which the Grantee owns at least a 5% interest.

While significant uncertainties exist about the future economic viability of AT&T Comcast, given the financial resources of the company and the reduction in its debt to cash flow ratio, this Office does not believe there is sufficient evidence to support denying the transfer based upon AT&T Comcast’s lack of financial responsibility. However, the OCC will exercise due diligence over the 42 months remaining in the franchise by monitoring financial information and providing Council its analysis upon request.

IV. Technical Ability:

Jointly AT&T and Comcast have each operated cable companies serving 22 million subscribers. The City would not have a reasonable basis for denying the transfer on grounds of insufficient technical ability.

V. Quality of Services Proposed.

AT&T Broadband currently provides video, Internet and telephony services to approximately 150,000 Seattle citizens. Mr. Brian Roberts, the new CEO of AT&T Comcast has indicated that he intends to continue AT&T Broadband's investment in expanding the availability of cable telephony. The City welcomes any head to head competition from facilities based providers. The company represents that the merger will allow for faster deployment of other new services like Video On Demand (VOD), High Definition Television (HDTV), and interactive television, which AT&T is currently testing on a limited basis in Tacoma. The company also plans to be a leader in the provisioning of home networking services, a broadband application that has a high likelihood for increasing demand. AT&T Broadband recently invested in broadband equipment that will permit it to more efficiently allocate bandwidth. This development will allow it to digitize local content, provide more on-demand services and tiered speed Internet service options. We are concerned that AT&T Comcast has not provided any information about the cost of the tiered Internet options, home networking service or charges for residential connections to corporate LANs, which are essential for telecommuting. The extent to which the company can make good on its intentions to roll out these new services in the near future and the degree to which these services can be priced to attract and sustain demand remain uncertain.

VI. Ability to Comply with Franchise and SMC

As mentioned above, the SMC requires Council to consider the ability of the transferee to comply with the franchise and applicable law. In light of this requirement it is appropriate to review the recent performance of the Franchisees. Normally, the most recent AT&T Broadband annual report would be submitted as part of this performance review. Although AT&T Broadband is required to provide performance information for 2001 in its annual report, AT&T has yet to provide its 2001 annual report, despite a May 1, 2002 due date. The City has notified AT&T of this franchise violation and is beginning the process of assessing a penalty to obtain compliance.

Office of Cable Communications Complaint Summary

In 2001, the Office of Cable Communications received over 1,100 queries, most of which constituted violations of the Cable Customer Bill of Rights. Among the most frequent violations were:

Customer Service - 251

- Inability to reach an operator
- Long telephone hold times
- CSR's giving wrong information on prices and other questions
- The Company's lack of knowledge about the Cable Customer Bill of Rights
- Technician is late or does not come to appointment

Outages and Service Interruptions – 375

- Modem service not up within 24 to 48 hours after the migration from @Home.com to attbi.com
- Lost E-mails and addresses following migration
- Cable outages

Problems Resolution – 183

- A refusal to put the customer in contact with a supervisor, or a supervisor's failure to follow through with the citizen
- CSR didn’t credit or waive fees

- Calls were not returned within 24 hrs.

Franchise Violations

In addition to the violations of the Cable Customer Bill of Rights, AT&T Broadband is also out of compliance with its franchise in a several areas. In Spring of 2001 it unilaterally closed one of its required subscriber service centers in Seattle without discussing with the City its impact on franchise requirements. The City has assessed liquidated damages for this violation and will require compliance. AT&T Broadband has also violated the reporting requirements of the franchise by failing to submit phone answering statistics during the period in which it transitioned its Internet customers from @Home to attbi and as mentioned failed to submit its annual report. We have conducted extended discussions about these matters with AT&T Broadband representatives and in a separate written agreement they have certified that AT&T Comcast will provide the City with an implementation plan to cure all outstanding franchisee violations by October 18, 2002.

Based on the foregoing the City has legitimate concerns about the ability of the transferee to faithfully abide by the terms of the franchise and applicable law. However, we are encouraged by AT&T's express written commitment to resolve these issues to the City's satisfaction. We also note that while any franchise violation is a serious matter the infractions detailed above do not rise to the level of concern as in 1999 when TCI defaulted on its obligation to rebuild the cable system. The OCC will work with AT&T Comcast to resolve these matters and will report progress to Council.

VII. Current Issues and Concerns

The following information is intended to provide Council with a better understanding of the relevant context in which the merger is taking place. The items below however are not part of the criteria by which Council determines whether to consent to the request for the transfer of control.

Recent FCC Decision Regarding Cable Modem Service

On March 14, 2002 the FCC issued a declaratory ruling that cable modem service is classified as an information service and not a cable service. It also initiated a rulemaking proceeding to determine the scope of local regulatory authority over cable modem service including the authority to impose multiple ISP requirements. The immediate effect of this decision is that the City is no longer receiving franchise fees on cable revenues generated from cable modem service. The City has notified the Franchisees that this decision is under appeal and the City reserves all of its rights should it be overturned. The Association of Local Organizations Against Preemption (ALOAP), an organization representing local governments, is leading the appeal process. The Washington Association of Telecommunications Officers and Advisors (WATOA) and The Office of Cable Communications will be filing comments to the FCC in this proceeding.

Open Access

The same FCC ruling included provisions that would deny independent Internet service providers (ISPs) access to the cable network on a non discriminatory basis. Although AT&T Broadband and Comcast have announced that they will allow a limited number of independent ISPs (such as Earthlink in Seattle) to use their network, it is still unclear how much extra consumers would have to pay for the right to use an independent ISP or how onerous the access fee will be to independent ISPs. Also of concern is the extent to which cable operators will dictate what these ISPs can sell, or what applications they can provide.

Applicability of City Utility Tax to Cable Modem Service

The City receives approximately $1.15 million from AT&T Broadband in utility taxes assessed on revenues generated from the provision of cable modem service. On April 29, 2002 AT&T Broadband belatedly informed the City that it had stopped paying this tax as of March 15, 2002. AT&T initially based its decision on a March 14, 2002 FCC ruling which classified cable modem service as an interstate information service; AT&T now also claims that under Washington law the tax does not apply. The City disagrees that the FCC ruling extinguishes AT&T Broadband's obligation to abide by the City's tax laws or that the City's utility tax does not apply. The City has decided that it can best seek resolution of this issue through the appropriate venues for resolving tax disputes.

Increasing Cable Rates

Cable rates have increased at twice the rate of inflation and are up approximately 45% since 1996. Just this month, AT&T Broadband will increase the price of its high speed Internet service by 15% from $39.95 to $45.95 yet many customers have indicated that average speeds are slower than they previously had. In addition, in some parts of King County outside of Seattle, AT&T is instituting a $4.00 service charge on Internet customers who do not also subscribe to cable television.

These increases are in addition to video rate increases of 10% in January 2002 and an upcoming increase of 7% to the cost of basic service, effective July 1. A recent study conducted by Consumers Union concluded that mega-mergers and consolidations such as the proposed AT&T-Comcast merger do not have a dampening effect on price increases by cable operators. To date only direct competition from wireline providers has had the desired effect on spiraling rate increases rates. Under current federal law, cable operators can raise rates (except for rates of basic tier of service and rental and installations) at will. There is a legitimate concern that continued price increases will widen the gap between technology haves and have-nots and thwart societal goals of achieving ubiquitous and affordable broadband connectivity.

Effect of Decreasing Cable Stock Valuations

Whether or not AT&T Comcast will be able to make good on its claims of rolling out advanced services such as video on demand and HDTV depends upon many factors including the uncertain economic times in the telecommunications industry. Wall Street is concerned about the entire telecommunications industry, including the highly leveraged position of cable operators and their stock valuations have decreased dramatically during the past year. As of June 5, 2002: AOLTime Warner was valued at $17.10 per share, off its 52 week high of $55.00; Charter Communications was valued at $6.07 off its 52 week high of $24.45; and AT&T Corp.'s shares were valued at $11.65 per share after trading over $70. a few years ago. Comcast, in comparison has not suffered as dramatically, trading at almost 60% of its 52 week high. Adding to the concern, Adelphia Corporation, the sixth largest cable operator in the country with 5.8 million subscribers will probably soon file for bankruptcy triggered primarily by questionable accounting practices of its founders, the Rigas family. Adelphia has seen its stock plummet from a 1999 peak of $87. to $0.82 on the over-the-counter market as of June5 after being delisted form the NASDAQ index. There is concern that Adelphia's experience could have a ripple effect further depressing the valuations of cable operators, particularly if Adelphia's assets are sold in a "fire sale" manner at bargain prices. Lower company valuations could inhibit AT&T Comcast's ability to refinance its debt or secure additional financing on favorable terms.

Media Consolidation and Potential for Abuse of Market Power

Telecommunications, cable and media companies are increasingly merging and forming alliances. A recent report by the Consumer Federation of America indicated that, "The FCC is considering relaxation of rules governing the size of cable companies and their ability to own alternative forms of media distribution." There is a growing concern that that the large media conglomerates could use their control of broadband infrastructure to restrict access to independent content and programming. In the case of cable operators, a specific concern is that they could use their market power in the residential broadband market to stifle broadband innovations such as streaming media that could compete with their video product.

VIII. Conclusions

Federal law and the Seattle Municipal Code permit the Council to review the qualifications of a transferee before approving a transfer of control. The Council can take into consideration the financial and technical qualifications of the proposed transferee, the services it proposes to provide and its ability to abide by the terms of the franchise and applicable law. Based on its review of all of the relevant factors, the Office of Cable Communications recommends that Council approve the transfer of control of AT&T Broadband and the Franchisees to AT&T Comcast, subject to AT&T Comcast agreement to all of the conditions of the proposed transfer ordinance (as referred to Council under separate cover). These conditions assure that the City will accomplish the following goals:

- Protect Seattle citizens;

- Reserve all of the City's rights under applicable law, including its right to conduct a complete renewal proceeding; and
- Ensure compliance with all franchise obligations and applicable law.

While there may be requests from some quarters for conditioning the transfer request upon AT&T Comcast's agreement to provide certain financial and service concessions not stipulated in the franchise, we believe that based on federal and local law, the transfer process is not the appropriate context for renegotiating franchise terms. Notwithstanding the above, the City has identified a preliminary list of issues it intends to discuss with AT&T Comcast during the renewal period which begins in January 2003. As part of the renewal process the City will conduct a comprehensive ascertainment process to determine the cable-related needs of the community. Those findings will provide part of the basis for franchise negotiations.

We recognize that some uncertainty remains about the economic viability of AT&T Comcast and other cable operators but do not believe that that fact in itself is a reasonable basis to deny the transfer request. Moreover, AT&T Comcast managers and executives have considerable experience in the cable industry and our consultant's financial analysis points out that AT&T Comcast has the means to improve its financial position.

We are currently satisfied with the assurances provided by AT&T Comcast that they will work in good faith to resolve all outstanding franchise issues to the City's satisfaction, within a specified period. We also look forward to working with AT&T Comcast to discuss other matters of mutual concern and note that in January 2003, the parties will begin extensive negotiations regarding the renewal of AT&T Comcast's operating rights within the City of Seattle.

Please contact me at 386-0070 if you would like additional information or have any questions about any of the information in this report.

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